SUMMARY OF COOPERATIVE CASES

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The comments on cases reviewed herein represent the personal opinion of the author and not necessarily the official views of the Department of Agriculture.

SPECIAL NOTICE

There will be three issues of the Summary in 1963 - April, August, and December

FEDERAL TAXATION - NONEXEMPT FARMERS' COOPERATIVE - AMOUNTS INCLUDABLE IN PATRONAGE REFUNDS

(Farmers Cooperative Grain Co. v. Commissioner, 39 T.C. No. 54 (Docket No. 68513), CCH Dec. 25,802)

In this case, a sequel to Pomeroy Cooperative Grain Co. v. Commissioner, 288 F. 2d 326, the cooperative contended that part of the storage and handling fees received from Commodity Credit Corporation should, despite the ruling in Pomeroy, be included in income properly allocable as patronage refunds and therefore properly excludable from income. The Tax Court, however, found nothing in the facts "to distinguish the handling charges in question from those considered in Pomeroy Cooperative Grain Co., supra. They were fees for services earned after title to the grain had passed to Commodity Credit Corporation and the income therefrom cannot be excluded from taxpayer's gross income."

A second issue presented involved the manner of computing the portion of the Grain Department business attributed to members. The Tax Court sustained the Commissioner on this issue also.

Petitioner is a purchasing and marketing cooperative, dealing in grain and farm supplies. These business activities are carried on in three departments, described in the computations of patronage dividends attached to the petitioner's income tax returns for the respective years as Grain, Petroleum and Merchandise, respectively. During the taxable years involved each of petitioner's three departments transacted business with nonmembers, as well as with members of the petitioner.

As indicated above, petitioner received certain storage and handling fees from Commodity Credit Corporation. After the Pomeroy decision, it conceded that some of these fees were not properly includable in patronage refunds. However, it contended that some of the fees received should be considered "patronage" even though paid by Commodity Credit Corporation because the economic burden of such fees fell on the patron members.

Excerpts from the Court's opinion on this issue follow:

> "It is well established that a nonexempt cooperative, such as petitioner, may exclude from gross income the earnings that qualify as patronage dividends. It is equally well settled that one of the prerequisites of a true patronage dividend is that the profit must have been derived from transactions with the members, to whom the allocation of patronage dividends is made, and not from nonmember business.

"The principal question to be determined here is whether certain storage and handling fees received by the petitioner from the Commodity Credit Corporation (a nonmember) for certain specified services, are excludable from petitioner's gross income as patronage dividends.

"In Pomeroy Cooperative Grain Co., 31 T.C. 674, (partially affirmed, Pomeroy Cooperative Grain Co. v. Commissioner, 288 F. 2d 326) we held with regard to a nonexempt cooperative, such as petitioner, 'that the amounts allocated by petitioner to its members only, out of the compensation which it received from the C.C.C. for handling and storing Government grain, are not excludable from petitioner's gross income, as part of its patronage dividends.' This holding was specifically affirmed by the Court of Appeals (Eighth Circuit) where, in the course of its opinion, that Court stated (288 F. 2d 326, p. 331):

> "The Tax Court was warranted on the record before us in determining that storage and handling charges collected by the taxpayer from the C.C.C. for services rendered after the C.C.C. had obtained title to the grain were not profit or income realized from transactions with member-patrons of the taxpayer.

"After our opinion in Pomeroy Cooperative Grain Co., supra, the Commissioner published Revenue Ruling 59-107, C.B. 1959-1, p. 20, and this ruling was specifically approved in the opinion of the Court of Appeals upon the appeal of that case (288 F. 2d, at pp. 330, 331).

"Petitioner's position here is that a breakdown of the storage and handling charges paid by the C.C.C. shows that some of the income it derives from such charges is properly allocable as patronage refunds and therefore properly excludable from its income.

"Petitioner states on brief:

> "Commodity Credit grain income breaks down into five categories:
>
> "(1) Income attributable to storage of grain subsequently taken over by Commodity Credit, such storage being earned prior to take-over date.

"(2) Income attributable to the handling (weighing, measuring, grading, and in-loading) of grain subsequently turned over to Commodity Credit earned prior to take-over date,

"(3) Income attributable to the handling of grain delivered to the elevator in satisfaction of a Commodity Credit loan or a Commodity Credit purchase agreement,

"(4) Income attributable to storage of Commodity Credit grain earned after take-over date,

"(5) Income attributable to the activity of loading out Commodity Credit grain after take-over date.

"That all storage and handling fees described in the above five categories were received from C.C.C. is not in dispute. Petitioner concedes categories 4 and 5 represent income from nonmember transactions, includable in its taxable income. With respect to category 1, it was stipulated that in fiscal 1954 and 1955 petitioner received from C.C.C. the sums of $122.11 and $1,883.74, respectively, from members and nonmembers as charges for storing of grain for the periods of time prior to the default by producers of their loan agreements and prior to the date of the take-over of the grain by the C.C.C. in satisfaction of the loan agreements with producers. Respondent concedes 85.59 percent and 81.09 percent of the respective amounts of $122.11 and $1,883.74, less expenses applicable thereto, may be excluded from petitioner's gross income for the fiscal years 1954 and 1955. Petitioner offered no testimoney that it was entitled to exclude any amounts in this category in excess of the amounts respondent conceded.

"There is no evidence in the record with respect to any income received by petitioner described in category 2, so we need not discuss it.

"The real controversy is with respect to category 3 or the income attributable to the <u>handling</u> of grain that is delivered to petitioner's elevator in satisfaction of a C.C.C. loan or purchase agreement. The three types of transactions here involved are, (1), where the grain is delivered to the elevator for weighing, grading and storage, (2), where the grain is delivered to the elevator for weighing, grading and immediate shipment, and (3) where

the grain is delivered to the elevator for weighing and grading and elevated to storage in Government owned bins.

"In support of its position that the handling charges for such described services for grain delivered in satisfaction of C.C.C. loans are deductible, petitioner argues the economic burden of these charges falls upon the grain producer. It is stipulated these charges were paid by C.C.C. There is nothing in the record to indicate such handling charges were deducted or even considered in computing the loan value of the commodity. The services were performed after the producer had notified the C.C.C. of his intention to deliver the grain in satisfaction of the loan and had received delivery instructions from the C.C.C. to deliver the grain to the elevator and the charges for the services were paid by the C.C.C. pursuant to its contract with petitioner. There is nothing in the record that indicates the economic burden of these charges falls on the producer.

"Some argument is made that the producer has the right to select the elevator to which the grain, to be delivered in satisfaction of his C.C.C. loan, is to be delivered. This seems of no significance but in any event the record would indicate he would have no more than a right to express his preference.

"The balance of petitioner's argument with respect to these handling charges being deductible from gross income is based upon suppositions of what might happen if certain events occurred. Petitioner argues the C.C.C. could refuse to treat the commodity as belonging to it if the grain does not satisfy as to quality or quantity and the producer would have the right to withdraw his grain if he rejected the weights and grades determined by producer. No document in the record seems to support such action. Provision is made for settlement of grade dispute by delivery of a sample to the nearest District Inspection Office of the United States Department of Agriculture. At any rate, there is no evidence in the record of any dissatisfaction and no instance of the C.C.C. refusing delivered commodity."

On the second issue, the Court said:

"Petitioner used the bushel as the unit of measure to compute the percentage of its Grain Department business that was attributable to member patronage and the percentage thereof that was attributable to non-member

patronage. Petitioner argues the total bushels of grain delivered to it by farmer-producers in satisfaction of C.C.C. loans should be included with total bushels of grain purchased by it in computing the portion of its Grain Department business attributable to transactions with its members. Respondent eliminated all grain delivered in satisfaction of C.C.C. loans from the total bushel-volume of Grain Department business and from the total bushel-volume of member business. Respondent's computation is right.

"We have held above that income received by petitioner from the C.C.C., a non-member, for handling and storing C.C.C. grain may not be excluded from income as patronage dividends. It follows from this holding that no consideration should be given to the number of bushels of such grain in computing the portion of its Grain Department income which may be excluded from its gross income as patronage dividends. Petitioner's computation, by including all of the grain handled by the Grain Department, results in a distortion of the percentage of Grain Department income properly attributable to its members for purposes of patronage dividends."

Same issues as were involved in above case were disposed of on basis of 39 T.C. No. 54 in the following cases:

1. Farmers Cooperative Co. v. Commissioner, T.C. Memo. 1963-44 (Docket No. 67268), CCH Dec. 25,966(M);

2. Klemme Cooperative Grain Co. v. Commissioner, T.C. Memo. 1963-45 (Docket No. 68498), CCH Dec. 25,967(M);

3. Wallingford Cooperative Elevator Co. v. Commissioner, T.C. Memo. 1963-46 (Docket No. 69006), CCH Dec. 25,968(M);

4. Farmers Cooperative Co. v. Commissioner, T.C. Memo. 1963-47 (Docket No. 70551), CCH Dec. 25,969(M);

5. Farmers Cooperative Co. v. Commissioner, T.C. Memo. 1963-48 (Docket No. 66553), CCH Dec. 25,970(M); and

6. Farmers Cooperative Co. v. Commissioner, T.C. Memo. 1963-49 (Docket No. 66553), CCH Dec. 25,971(M).

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FEDERAL TAXATION - NONEXEMPT FARMERS' COOPERATIVE - AMOUNTS ALLOCATED TO EMPLOYEES NOT EXCLUDABLE AS PATRONAGE REFUNDS

(Farmers Cooperative Co. v. Commissioner, T.C. Memo. 1963-43 (Docket No. 68637), CCH Dec. 25,965(M))

The only previously undecided issue in this case (which could not be disposed of on the basis of Pomeroy case and 39 T.C. No. 54 reported above) was whether amounts allocated to a cooperative's employees, based upon the amount of salary earned, were excludable as true patronage dividends from the cooperative's gross income. The Tax Court held they were not excludable.

During the years involved petitioner (a purchasing and marketing cooperative dealing in grain and farm supplies and carrying on its business through three departments known as the Grain, Merchandise and Petroleum Departments) issued patronage dividend certificates to its employees based upon the amount of salary or wages earned and such dividends were allocated at the same rates as used for allocation of profits of the petitioner's Merchandising Department. Those rates for the taxable years ending March 31, 1953, March 31, 1954, and March 31, 1955, were respectively 3.8 percent, 5 percent, and 5 percent. The employees did not receive these so-called patronage dividends in cash but the amounts of the certificates were set up on petitioner's books as liability items. During the years in question all but two of petitioner's employees to whom it issued such patronage dividend certificates were also members of petitioner.

The Court said in part:

> "Petitioner was organized as a cooperative corporation under the provisions of Chapter 389 of the 1931 Code of Iowa, now Chapter 497 of the 1958 Code of Iowa, which provides that portions of the net profit shall be set aside for a reserve fund, an educational fund, and to pay a dividend on stock, and then provides (in Sec. 497.19, Iowa Code of 1958), as follows:
>
> > "497.19 Additional dividends
> >
> > "The remainder of said net profits shall be distributed by uniform dividends upon the amount of purchases of shareholders, and upon the wages and salaries of employees. In producing associations, such as creameries, canneries, elevators, factories, and the like, dividends shall be on raw material

> delivered instead of on goods purchased. In case the association is both a selling and a producing concern, the dividends may be on both raw material delivered and goods purchased by patrons.

"Petitioner's articles of incorporation provided that the earnings of the corporation 'shall be apportioned' as provided in the above statute.

"Petitioner states its position to be:

> "The philosophical approach of this type of statute considers the labors of the employees, as measured by their wages and salaries, in the same category as the purchase of commodities from members. That is to say, the commodities purchased and the labors contributed in their handling alike contribute to the savings made when the products are sold; thus not only is the producer of the commodity entitled to a patronage refund, based upon the volume of goods he has put through the cooperative, but also the employee is entitled to a patronage refund based upon his efforts and contributions to the savings through his labors. * * *

"In Pomeroy Cooperative Grain Co., 31 T.C. 674, we pointed out there was no statute specifically providing for exclusions or deductions for patronage dividends by nonexempt cooperatives but administrative practice and judicial authorities had long sanctioned exclusions of true patronage dividends under certain conditions. There we pointed out 'such administrative practice is recognized, at least indirectly, both in section 101(12)(B) of the 1939 Code and in section 522(b)(2) of the 1954 Code, wherein it is stated: "Patronage dividends, refunds, and rebates to patrons with respect to their patronage * * * shall be taken into account in computing net income /of an exempt cooperative/ in the same manner as in the case of a cooperative association not exempt."'

"The theory on which such exclusion of patronage dividends is based is, as we said in the Pomeroy case, that 'true patronage dividends are, in reality, either (a) additions to the prices initially paid by the cooperative to its patrons for products which the patrons had marketed through the cooperative, or (b) refunds to patrons of part of the prices initially paid by them for merchandise or services which they had obtained through the cooperative. Thus, the administrative practice is to treat true patronage dividends as corrective and deferred price

adjustments, which serve to reduce the amount of the cooperative's gross profit from sales, and which actually never became part of its gross income.'

"The amounts allocated by petitioner to its employees do not qualify as true patronage dividends. The employment of an employee is not a transaction out of which profits arise. In fact, it has the effect of reducing profits. Allocations to employees based on their wages are not out of profits realized from patron transactions. Actually here they were made out of profits realized from transactions with patrons of the petitioner's Grain, Merchandise and Petroleum Departments. It cannot be said such allocations to employees based on wages represent either an additional compensation due the patron for goods marketed through the cooperative or a refund of a part of the price initially paid by the patron. In the words emphasized in <u>Pomeroy Cooperative Grain Co.</u>, <u>supra</u>, such an allocation of earnings to employees does not represent '<u>corrective and deferred price adjustments</u>.'

"Although the laws of Iowa may provide how and to whom the earnings of a cooperative association should be distributed or allocated, we must look to the Internal Revenue Code, the Federal Court decisions and the administrative rulings in deciding the portion of such earnings excludable from Federal income tax. <u>Pomeroy Cooperative Grain Co.</u>, <u>supra</u>.

"The rule to be drawn from these sources is that in order for the patronage dividend of a nonexempt cooperative to be excludable from Federal income tax the allocation must have been (1) pursuant to a legal obligation existing at the time of the patron transaction; (2) the allocation must have been made out of profits realized with the particular patrons for whose benefit the allocations were made and not out of non-patron transactions; and (3) the allocations must be made equitably to members upon the basis of business transacted with members. <u>Pomeroy Cooperative Grain Co.</u>, <u>supra</u>, and authorities cited; <u>Pomeroy Cooperative Grain Co.</u> v. <u>Commissioner</u>, 288 F. 2d 326.

*   *   *   *   *

"The dividends to employees based on salaries do not satisfy the second requisite of true patronage dividends for income tax exclusion in that they are not made out of profits or income realized from transactions with those who benefit from the allocations.

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INTERNAL REVENUE SERVICE ADOPTS POMEROY CASE RULE ON DEPARTMENTALIZATION ISSUE

(Rev. Rul. 63-58, 1963 Int. Rev. Bull. No. 14, at 11)

The Internal Revenue Service has ruled that a cooperative may treat its marketing and storage activities as an integrated business unit if the same storage and handling facilities are used by it for both activities. The cooperative, in order to accurately compute the amount allocable to members as patronage dividends, should keep permanent records to show amount of business done with members and nonmembers.

The ruling reads as follows:

> The Internal Revenue Service clarifies its position, in the light of the opinion of the United States Court of Appeals for the Eighth Circuit in Pomeroy Cooperative Grain Co. v. Commissioner, 288 Fed. (2d) 326 (1961), with regard to whether the marketing activity of a cooperative may be combined with its storage activity so that the two aspects of the business are treated as a unit.
>
> In the Pomeroy case, the Court of Appeals concluded that the taxpayer's grain business was an integrated business, that is, that the same storage and handling facilities were used by the taxpayer in its marketing and storage activities and that patrons were credited with the number of bushels of grain delivered without regard to whether they were for sale or for storage.
>
> Therefore, where other cooperatives are operated in a substantially similar manner, the storage and marketing activities may be treated as a unit. However, where a cooperative distributes profits only to member patrons, the Federal income tax exclusion will be limited to that portion of the dividend attributable to member business. This is in accord with the well established principle affirmed in the Pomeroy case that a distribution is not a true patronage dividend to the extent that it is out of earnings from business done with nonmember patrons to whom no amounts are paid.
>
> Accordingly, it is essential that cooperatives keep permanent records to show the business done with nonmembers and that done with members. Where, for example, 20 percent of the bushels delivered for storage and 60 percent of the bushels delivered for marketing are attributable to transactions with members, only 20 percent of the income from storage may be combined with 60 percent of the income from marketing and the aggregate net

> profit may be distributed to the members ratably on the basis of the number of bushels which they delivered to the cooperative. In the absence of unusual circumstances in a particular case, in determining the ratio of member to nonmember business, it will not be necessary to make the computation on a crop by crop basis.

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FEDERAL TAXATION - COOPERATIVE HOUSING CORPORATION-
PRINCIPAL PAYMENTS - PATRONAGE REFUNDS

(Lake Forest, Inc. v. Commissioner, T.C. Memo. 1963-39, (Docket Nos. 77061, 81891) CCH Dec. No. 25,957(M))

The decision of the Tax Court in this case will be of interest not only to housing cooperatives but to other cooperative corporations, including farmer cooperatives.

The Fourth Circuit Court of Appeals, in a decision reported at 305 F. 2d 814 (1962), reversed an earlier decision of the Tax Court and held that this organization was not exempt either as a "social welfare" organization under Sections 101(8) of the 1939 Code and 501(c)(4) of the 1954 Code or as a "like organization" under Section 101(10) of the 1939 Code and 501(c)(12) of the 1954 Code. It then remanded the case to the Tax Court to decide six issues raised by Lake Forest, Inc., and not previously reached by the Tax Court.

On these issues the Tax Court reached the following conclusions (taken from the headnote summary):

> "1. Except where section 302(b) of the Revenue Act of 1950 applies, exempt organization information returns are not 'returns' for statute of limitations purposes under the 1939 Code.
>
> "2. Petitioner's claim to exemption under section 101(8), 1939 Code, failed because it was not a 'social welfare organization.' Held: section 302(b) of the Revenue Act of 1950 is inapplicable.
>
> "3. Petitioner, a cooperative housing corporation, held to have leased, not sold, its dwelling units to its members.
>
> "4. Held: petitioner's dwelling units were depreciable property in its hands, since it held them for the production of income.

"5. Principal payments to petitioner by its members held: contributions to capital and not income to petitioner.

"6. Patronage refunds qualifying as such under the tests in Pomeroy Cooperative Grain Co., 31 T.C. 674 (1958), affd. in part 288 F.2d 326 (C.A. 8, 1961):

"(a) Need not be payable in cash;

"(b) May arise from additions to funded reserves for anticipated expenses; and

"(c) Need not, during the years before the Court, have been allocated by the due date of the payor's income tax return.

"7. Additional State income taxes and interest due on account of any deficiency found here are not deductible by petitioner, an accrual basis taxpayer, in the years to which the additional taxes relate. Globe Tool and Die Manufacturing Co., 32 T.C. 1139 (1959).

"8. Petitioner's taxable status prior to the years before the Court held: the same as that determined for the years before the Court. A net operating loss incurred in the earlier period may be carried forward."

In agreeing with the petitioner on the issue as to whether the members' principal payments were contributions to capital, the Court said, in part:

"Respondent's contentions, other than the allegation of inconsistency between allowing both depreciation deductions and the principal payments exclusions, were considered and rejected by this tribunal in Paducah & Illinois Railroad Co., 2 B.T.A. 1001 (1925); 874 Park Avenue Corporation, 23 B.T.A. 400 (1931); and Cambridge Apartment Building Corporation, 44 B.T.A. 617 (1941), the latter two cases involving cooperative apartment house corporations. The Commissioner acquiesced in the decisions in all three cases. VII-1 C.B. 24; X-2 C.B. 21; 1941-2 C.B. 2. See I.T. 1469, I-2 C.B. 191 (1922). We have found that the principal payments were credited to an account entitled 'Members Equities' and were so shown on petitioner's financial statements. Petitioner's members were advised of their principal payments and accumulated equities by published schedules and individual members' equity records. These payments were applied each year to

amortization of petitioner's mortgage indebtedness to the United States. 36 T.C. at 525. These facts bring this case squarely within the above-cited decisions. Respondent has suggested no contrary authority and we have found none.

*   *   *   *   *

"It seems clear that if petitioner's members had contributed the entire purchase price at the time petitioner bought the property from the United States Government, then petitioner could both exclude the contributions from income and deduct depreciation on the depreciable property purchased with such contributions. We fail to see a significant difference where petitioner's members make their capital contributions in installments instead of all at once.

"We do not interpret any of the recently-decided cases dealing with whether certain payments by stockholders were contributions to capital or payments for services rendered or to be rendered, to require a different decision in this case. See Federal Employees' Distributing Co. v. United States, 206 F. Supp. 330 (S.D.Cal., 1962), on appeal C.A. 9. Cf. James Hotel Company, 39 T.C. ___ (October 16, 1962, pp. 8-9) on appeal (C.A. 10, January 17, 1963); United Grocers, Ltd. v. United States, 308 F. 2d 634 (C.A. 9, 1962); Affiliated Government Employees' Distributing Co., 37 T.C. 909 (1962)."

Under petitioner's amended charter and bylaws, after October 1, 1954, petitioner "treated as loans from members, for which they would be given credit on the books at the end of the corporation's fiscal year" (36 T.C. at 528) each year's operating surplus and the annual additions to petitioner's reserve for repairs, replacements, and maintenance and petitioner's reserve for vacancies and collection losses. Petitioner included these "book credits" as expenses and deducted them from income.

The Tax Court approved this treatment. It said, in part:

"Respondent's * * * arguments do not destroy petitioner's exclusion from income under the Pomeroy tests. It is not relevant that the book credits may not be paid in cash until petitioner has extinguished its mortgage indebtedness. Farmers Cooperative Company v. Commissioner, 288 F. 2d 315, 318-324 (C.A. 8, 1961), reversing on another point 33 T.C. 266 (1959). The Court of Appeals there notes (288 F. 2d at 320) that although it agrees with the reasonableness of the Commissioner's contention that a cooperative's exclusion of patronage refunds from income should be geared to includibility in the income of the patron (with exceptions not here relevant), nevertheless,

that is not how the law developed. * * * Farmers Cooperative and the matters there cited make it clear that the likelihood of eventual cash payment is not a requisite for exclusion from income of cooperative patronage refunds.

"Respondent's argument that no deductions may be taken because of additions to reserves for estimated expenses (except presumably, in the case of bad debts (section 166(c) of the 1954 Code)) is also not material, since petitioner here seeks exclusions from income, not on account of its additions to the reserves but rather on account of its allocations of the added amounts to its members. The tests we laid down in Pomeroy do not differentiate between operating surpluses and reserves for particular purposes."

In reaching the decision 6(c), above, the Court traced the history of Treasury rulings and court decisions relating to when a patronage refund must be disclosed to patrons by nonexempt corporations. Based on this review it decides that "the allocations herein, each made within the taxable year immediately following the one to which it related, were timely for the years before us."

The following comments on necessary adjustments in the patronage refunds or book credits may also have some lessons in them for other cooperatives:

"On its returns for its taxable years 1955 (nine months after October 1, 1954) and 1956, petitioner included depreciation in its schedules of 'Operating and Other Expenses' and then reduced its deductions by equal amounts on its 'Statement of Earnings' with notations to the effect that such depreciation was not used in calculating members' book credits, i.e., did not reduce the amount available for patronage refunds of operating surplus. The effect of these computations was to avoid a double reduction of taxable income on account of a single amount. Since excludable patronage refunds in the case of a purchasing cooperative[1/] are properly a return of collections which exceeded expenses, a book credit return of an item which also was properly treated as an expense would not be a true patronage refund. This consideration will be taken into account in a Rule 50 computation. See issue (2), supra.

"In each of the two years involved in this issue, there was a difference between the book credits allocated to members

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"1/ A housing cooperative more closely resembles a cooperative purchasing of facilities and services than a cooperative selling of products or services generated by its members.

on account of excess revenues and additions to funded reserves on the one hand and the corresponding patronage refunds deducted on the returns on the other hand. The returns indicate that the excess revenue book credits deducted on the returns were derived by adding back to the actual excess revenues, the amounts of Federal and State income taxes and a 'charge off of refrigerators and ranges sold or discarded,' and then reducing such sums by the amounts of nonmember income for the years involved. The returns do not explain the differences in the reserve accounts book credits. The amounts excludable as patronage refunds in the Rule 50 computation will not exceed the amounts actually allocated to petitioner's members nor will the excess revenue book credits include amounts in addition to net after-tax revenue from members.

"The book credits forfeited by a member who leaves before the end of petitioner's fiscal year and sells his membership to petitioner are allocated to the remaining members. These amounts have not arisen from the patronage of those to whose accounts they have been credited. Under the Pomeroy tests, supra, these reallocated amounts are not excludable from petitioner's income."

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FEDERAL TAXATION - EXEMPT COOPERATIVE - TREATMENT OF REFUND OF ILLEGAL TAX AND RECOVERY EXPENSES

(California and Hawaiian Sugar Refining Corp. v. United States, 311 F. 2d 235 (1962))

In this case, involving two separate but related issues, the Court of Claims held (1) that an agricultural marketing cooperative's exemption from the Federal income tax, at a time when it paid unconstitutional excise taxes, bars the inclusion of a refund of those taxes in its gross income for the year of its receipt even though at that time the cooperative was subject to income tax, and (2) that the cooperative's legal expenses incurred in obtaining these refunds are deductible as business expenses even though such refunds are considered a return of capital.

California and Hawaiian Sugar Refining Corporation is an agricultural marketing cooperative engaged in refining and marketing the sugar cane grown by its patrons. During 1934 and 1935, while it was exempt from all Federal income taxes, the cooperative paid the processing taxes and floor stock taxes imposed by the Agricultural Adjustment Act of 1933. In 1953, after invalidation of the Act, the cooperative received refund payments totalling \$970,507.41, and payments of interest totalling \$1,042,624.02. Of this amount, none was allocated to its patrons.

When the cooperative filed its income tax return for the taxable year 1953, it included the interest payments as income but did not include the principal amounts of the refunds as gross income. The cooperative also deducted, as an ordinary and necessary business expense, $269,372.46, which it incurred for legal and expert-witness fees in conjunction with the litigation to secure the refund.

In 1959, the cooperative was assessed $499,163.85, plus interest, by the Commissioner of Internal Revenue for a deficiency in its 1953 income taxes. The Commissioner based the deficiency on the inclusion of the principal amount of the tax refunds in gross income. The cooperative paid the assessment with the interest and subsequently filed suit to recover these payments.

The cooperative contended that because it received no income tax benefit from the payment of the unconstitutional taxes in 1934 and 1935, while it was not subject to Federal income taxation, the refunds paid in 1953 would be a non-taxable return of capital.

The Court, in upholding this position, said in part:

> "An established principle, under the general provision of the Internal Revenue Code of 1939 (Sec. 22(a)) taxing 'gains, profits, and income * * * from any source whatever,' is that a refund of taxes illegally collected in prior years is not taxable income in the refund year unless the taxpayer had previously obtained a tax benefit on account of those taxes. Theoretically, a recovery of monies wrongfully exacted by the Government is not income at all but a return of capital funds illegally taken from the taxpayer; where, however, the taxpayer has utilized the original impost to reduce income taxes, it is fair 'to take /taxpayer/ at its word' (See Ben Bimberg & Co., Inc. v. Helvering, 126 F. 2d 412 (C.A. 2, 1942) cert. denied, 317 U. S. 641) and to consider the refund as a new gain. This general justification for the tax benefit rule (in the present type of case) was spelled out by this court in Perry v. United States, 160 F. Supp. 270, at page 271, 142 Ct. Cls. 7, at page 9 (1958), involving the refund to a taxpayer of charitable contributions which he had made in prior years, where the court, speaking through Judge Whitaker, said that 'the return to the taxpayer of the property he had tried to give away cannot possibly be considered as income - he merely got back his own property. It cannot possibly be considered as income, except on the ground that he had deducted from his income the amount contributed in each year, thus reducing his taxes.' In the same case, Judge Madden, in a dissent on another point (joined by Judge Laramore) remarked (at page 12 of 142 Ct. Cls., at page 273 of 160 F. Supp.) that 'one does not ordinarily acquire taxable income by collecting a debt, or by a

refund of taxes which he never should have had to pay. The reason that the money was regarded as taxable in the special cases referred to was that, once having used the taxes paid or the bad debt as a tax deduction, the prospect of recovery was, for income tax purposes, written off, though as a legal claim it still existed. Having been written off, the later realization of the claim was, again for tax purposes, like a windfall to the taxpayer, and within the broad definition of taxable income.'

"This principle is reflected in the many cases holding a refund of taxes includible in the taxpayer's income of the recovery year where a tax benefit of some sort has been found, but not in its absence.

"At the time /cooperative/ paid the processing and floor stock taxes it was, as we have said completely exempt from Federal income taxation. Even as to reserves established out of earnings and retained without allocation to members, it incurred no income tax liability. It was only later that Section 101(12) of the Internal Revenue Code of 1939 was amended to curtail this attribute of exemption for the cooperative. * * * Since the cooperative, to the extent it incurs an income tax liability, is treated as an entity separate and distinct from its patrons, the nature of recovery by the cooperative is not governed by the existence or nonexistence of a prior tax benefit to the patrons. * * * In the future when the cooperative pays or allocates the refunded amounts to the shareholders and patrons, they will include them in their gross incomes. But while those sums remain in the cooperative treasury they are not income for 1953 and not treated or subject to tax as such."

On the issue of whether the legal expenses incurred in obtaining the refund are deductible, the Court upheld the cooperative's contention that this was a permissible deduction within the scope of Section 23(a) (which contains general authority for deducting "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *.") rather than a non-deductible expenditure under Section 24(a)(2), as contended by the Commissioner. The Court said that even though the tax refunds were returns of capital and not income, the scope of Section 24(a)(2) and its implementing regulations "normally apply to tangible or intangible property which has a basis."

Judge Whitaker dissented on both holdings; Chief Judge Jones on the expense issue.

TRADE REGULATION - UNREASONABLY LOW PRICES' BAN RULED VALID

(United States v. National Dairy Products Corp., 372 U. S. 29, 83 S. Ct. 594, 9 L. Ed. 2d 561 (1963))

The Robinson Patman Act's criminal provision against "unreasonably low prices" (Section 3; 15 U.S.C. 13a) passed muster before the United States Supreme Court. It was held to be not unconstitutionally vague when applied to sales made below cost for the purpose of destroying competition.

In the majority opinion, Mr. Justice Clark finds that the test of the statute's constitutionality may be made on the basis of the conduct alleged in the indictment, although National Dairy had contended that Section 3 must be tested solely "on its face." The opinion states in part:

> "It is true that a statute attacked as vague must initially be examined 'on its face,' but it does not follow that a readily discernible dividing line can always be drawn, with statutes falling neatly into one of the two categories of 'valid' or 'invalid' solely on the basis of such an examination.
>
> "We do not evaluate Section 3 in the abstract.
>
> *   *   *   *   *
>
> "The strong presumptive validity that attaches to an Act of Congress has led this Court to hold many times that statutes are not automatically invalidated as vague simply because difficulty is found in determining whether certain marginal offenses fall within their language. * * *
>
> "Void for vagueness simply means that criminal responsibility should not attach where one could not reasonably understand that his contemplated conduct is proscribed. United States v. Harriss, 347 U. S. 612, 617 (1954). * * * In view of these principles we must conclude that if Section 3 of the Robinson-Patman Act gave National Dairy and Wise sufficient warning that selling below cost for the purpose of destroying competition is unlawful, the statute is constitutional as applied to them. This is not to say that a bead-sight indictment can correct a blunderbuss statute, for the latter itself must be sufficiently focused to forewarn of both its reach and coverage."

The Court then turns to the legislative history to show that selling below cost, unless mitigated by some acceptable business exigency, was intended to be prohibited by the words "unreasonably low prices." In answer to the argument that the phrase "below cost" is equally vague, he said that the evidence presented at the trial of the case might render this issue academic. It might be shown that the sales complained of were made below cost under any rational concept of cost.

The Court, finally, emphasizes the presence in both the statute and the indictment of the additional element of predatory intent. The Act, the Court said, in requiring such an intent "provides further definition of the prohibited conduct. * * * It seems clear that the necessary specificity of warning is afforded when, as here, separate, though related, statutory elements of prohibited activity come into focus on one course of conduct."

The Court also finds adequate grounds to distinguish United States v. Cohen Grocery Co., 255 U. S. 81 (1921), strongly relied on by National Dairy, where a statute prohibiting "any unjust or unreasonable rate or charge" was held void for vagueness. However, Justices Black, Stewart, and Goldberg, dissenting, said they could see no difference between this case and the earlier case.

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TRADE REGULATION - MONTANA MILK CONTROL ACT HELD VALID

(Montana Milk Control Board v. Rehberg,
___ Mont. ___, 376 P. 2d 508 (1962))

The price fixing provisions of the Montana Milk Control Act were held not to offend due process and not to unconstitutionally delegate legislative power, in an injunction suit brought by the State Board to restrain Rehberg from selling milk for consumption at a price less than the minimum set by the Board.

The Court declined to follow two recent Southern cases (Harris v. Duncan, 208 Ga. 561, 67 S.E. 2d 692 (1951) and Gwynette v. Myers, 237 S.C. 17, 115 S.E. 2d 673 (1960)) on the ground that these were admittedly in the minority. Milk Control Acts have been upheld in many States. It preferred the test set forth in Nebbia v. New York, 291 U. S. 502 (1934) in which the United States Supreme Court said:

> "/T/he guaranty of due process * * * demands only that the law shall not be unreasonable, arbitrary, or capricious, and that the means selected shall have a real and substantial relation to the object sought to be attained."

The Court found the Montana statute to come within this test.

As indicated above, the Court also concluded that the Act was not defective as an unconstitutional delegation of legislative power. Defendant had asserted that the legislature "did not sufficiently establish a legislative policy to fix prices," nor did it "prescribe adequate standards and guides in attempting to delegate powers." The Court rejected both contentions, finding the law complete as to what the law required and "sufficiently clear, definite and certain to enable the agency to know its rights and obligations."

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TRANSPORATION - LEASING ARRANGEMENTS
HELD FOR-HIRE CARRIAGE

(John J. Casale, Inc. v. United States,
208 F. Supp. 55, aff'd 83 S. Ct. 311 (1962))

Casale had set up an arrangement under which he would lease a motor vehicle, with drivers who were his employees, to lessees for alledgedly private carriage operation beyond the New York commercial zone. Under the contract, the trucks were leased for a flat amount plus a mileage charge; Casale provided a complete payroll service with lessee being furnished a weekly statement showing the rental charge for the equipment plus the direct labor costs such as drivers wages, fringe benefits, social security, unemployment insurance, workman's compensation, taxes, pension, and welfare benefits; and Casale paid the drivers. The Interstate Commerce Commission had determined this was for-hire carriage requiring an application and denied the carrier's application. Casale sued to have the order reviewed. The District Court sustained the Interstate Commerce Commission on the authority of United States v. Drum, 368 U. S. 370 (1962). On direct appeal to the Supreme Court, this decision was affirmed.

Compare, Schultz Transit, Inc. v. United States, 208 F. Supp. 537 (1962), in which a similar leasing arrangement was enjoined by a United States District Court in Minnesota, also on the authority of United States v. Drum, supra.

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